**Internal Revenue Service**

**memorandum**

CC:TL-N-4213-89
TS/JROSENBERG

date: MAY 26 1989

to: District Counsel, Laguana Niguel
Attn: Frank Bailey

from: Assistant Chief Counsel, (Tax Litigation) CC:TL

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subject: Wind Turbine Shelters

This memorandum responds to your request for tax litigation advice dated February 28, 1989, concerning the legislative history of the business energy credit.

ISSUE

Whether legislative history indicates any distinction between the business energy credit and the investment tax credit which a court may rely on to find the holding in Friendship Dairies v. Commissioner, 90 T.C. 1054 (1988), regarding the need for economic profit without taking the investment tax credit into account as inapplicable to the business energy credit.

CONCLUSION

The legislative history of the business energy credit indicates that the credit is an addition to the regular investment tax credit provision, and that the rules for applying the regular investment credit will also generally apply to the business energy credit. There is nothing in the legislative history to indicate any distinction between the business energy credit and the investment tax credit regarding the analysis of economic substance. Therefore, we conclude that the Court's holding in Friendship Dairies regarding the need for economic profit without taking the investment tax credit into account is also applicable to the business energy credit.

DISCUSSION

In an earlier memorandum dated November 17, 1988, (a copy of which was attached to your request) from our office concerning wind energy shelters, we discussed whether it is appropriate to factor in the available income tax benefits when determining the fair market value for wind turbine generators utilizing a

discounted cash flow analysis. We concluded that tax benefits should not be separately factored in when determining the asset's fair market value. Our position was based in part upon Tax Court cases where the Court had to determine if certain tax shelter transactions had economic substance to enable the taxpayer to claim available deductions and credits from their investment. In addition, although it was beyond the scope of our earlier memorandum, we stated in footnote 6 that as in Friendship Dairies, supra, when determining the economic profitability of an investment, tax benefits should not be used to transform unprofitable transactions into profitable ones even with alternative energy investments.

In your memorandum requesting this tax litigation advice, you state that it is generally presumed by attorneys in your region that the purpose of the business energy credit was to promote development of alternative sources of energy which would not otherwise be profitable. Because of this presumption, you believe that the business energy credit should be treated differently from the investment tax credit when determining economic profit. However, based on our analysis of the legislative history of the business energy credit and recent case law, it is our position that the business energy credit should be treated the same as the investment tax credit for purposes of determining economic profitability.

I.R.C. § 38 prior to its repeal by the Tax Reform Act of 1986 provided for a credit for investment in certain depreciable property. The credit is allowable on "section 38 property", which is defined in section 48(a)(1) as property which is subject to the allowance for depreciation. The amount of the credit is limited to the percentage of a taxpayer's qualified investment in section 38 property. Section 46(a)(1).

Section 46(a)(1) allows an additional percentage credit for investments in energy property. The energy percentage is determined in accordance with the provisions of section 46(a)(2). Section 48(1)(2)(A)(ii) defines energy property to include among other things, solar or wind energy property. Section 48(1)(4)(A)-(C)further defines "solar or wind energy property" as any equipment which uses solar or wind energy, to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat.

As a general rule the Tax Court does not separately consider tax benefits in determining economic profit. See Friendship Dairies, supra; Soriano v. Commissioner, 90 T.C. 44 (1988). In Friendship Dairies, the Tax Court analyzed whether a computer sale-leaseback arrangement had economic substance. The Court found that the sale-leaseback arrangement had no possibility of economic profit without taking the tax benefits into account.

The Court concluded that the investment tax credit should not be utilized as a substitute for, or component of, economic profit. In reaching this conclusion, the Court cited to Fox v. Commissioner, 82 T.C. 1001 (1984). Fox provided that losses from "essentially tax-motivated transactions which are unmistakably within the contemplation of congressional intent" are allowable despite the lack of a primary profit motive under section 165(c)(2). Fox at 1021. Friendship Dairies stated that a similar analysis is appropriate when determining profit potential in an economic substance analysis. The Friendship Dairies Court reviewed the legislative history behind the investment tax credit and concluded that, while the credit was intended to stimulate investments, it was not "intended to transform unprofitable transactions into profitable ones." Friendship Dairies, supra at 1065. See also Goldwasser v. Commissioner, T.C. Memo. 1988-523, slip op. at 23 n. 19.

We believe that a similar analysis of the legislative history of the business energy credit is appropriate in this situation to determine the economic profitability of an alternative energy investment. The business energy credit was adopted as part of the Energy Tax Act of 1977, Pub. L. 95-618, 92 Stat. 3183, 1978-3 (Vol.2) C.B. 1. Congress enacted the business energy credit for the purposes of encouraging greater use of energy sources other than oil and natural gas and to increase energy conservation by businesses. H. Rept. No. 496, 95th Cong. 1st Sess. (1977), 1978-3 (Vol.2) C.B. 71, 179; S. Rept. No. 529, 95th Cong. 1st Sess. (1977), 1978-3 (Vol.2) C.B. 199, 263. As is the case with the investment tax credit, at no point does the legislative history of the business energy credit state that the credit was intended to transform unprofitable transactions into profitable ones.

Moreover, the legislative history indicates that the business energy credit is an addition to the regular investment tax credit provisions and, as a result, the rules for applying the regular investment tax credit will also generally apply to the business energy credit. H. Rept. No. 496, supra at 179. For example, business energy credits will be absorbed using the first-in first-out (FIFO) rules which apply to the regular investment credit. Business energy credits may also be carried back for three years and carried forward for seven years, as is the case with the regular investment credit. H. Rept. No. 496, supra.

Since the purpose behind the enactment of the business energy credit is to encourage greater use of energy sources other than oil and gas, we would agree that wind energy turbines are a type of alternative energy source that would be considered to be congressionally approved and encouraged. However, regardless of this fact, we find nothing in the legislative history to indicate

any distinction between business energy credits and investment tax credits which a court may use to find the holding in Friendship Dairies, supra, regarding the need for economic profit without the investment tax credit as inapplicable to the business energy credit.

Additionally, in Kaba v. Commissioner, T.C. Memo, 1989-148, the Tax Court relied on the holding in Friendship Dairies, in disallowing deductions and business energy and investment tax credits claimed by the petitioners from an alternative energy investment. In Kaba, the Court determined that the transaction at issue was identical in most respects to the transactions previously dealt with in Soriano v. Commissioner, 90 T.C. 44 (1988) and Heasley v. Commissioner, T.C. Memo. 1988-408.1/ As in Soriano and Heasley, the petitioners in Kaba invested in a partnership which leased energy management equipment from O.E.C. Corp. under a plan whereby the partnership lessee would retain a service company to install and maintain the units in the facility of the end user. The partnership claimed a deduction for advance rental payments and investment tax credits and business credits arising out of the venture. The Court disallowed all the deductions and tax credits claimed from the investment on the grounds that the petitioners did not have the requisite profit objective. Kaba, supra, slip op. at 13. In making this determination of economic profit, the Court in Kaba, cited to Friendship Dairies, in stating that "[p]rofit means economic profit, independent of tax savings . . . [and] [t]he investment tax credit is not a substitute for or component of economic profit," Kaba, supra. slip op. at 13.

Based on the Court's holding in Kaba, of disallowing both the energy tax credits and investment tax credits claimed by the petitioners because of the lack of economic profit from their alternative energy investment, the Kaba case thus provides additional support for our position that the need for economic profit without the investment tax credit, is also applicable to the business energy credit.

Your memorandum also requested tax litigation advice regarding whether the legislative history of the State of California business energy credit of 25% should be considered, and, if so, what its affect is on the exclusion of the tax credit from a determination of economic profitability and fair market value. As a general rule, profit equals economic profit independent of tax benefits. Friendship Dairies v. Commissioner,

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1/ In our earlier memorandum regarding wind turbine generators we erroneously stated that Soriano was a computer leasing investment case. We correctly note that Soriano involved leased energy management equipment.

supra; Herrick v. Commissioner, 85 T.C. 237(1985); Surloff v. Commissioner, 81 T.C. 210 (1983). State tax credits may not be included in computing economic profit for federal income tax purposes because doing so might enable unprofitable activities to be treated as "profitable" activities thereby circumventing Congress' intent that federal credits are available only for genuinely profit oriented activities.

In conclusion, we acknowledge there is some merit to the argument that the business energy credit should be taken into account in some manner in determining the economic profitability of an alternative energy investment. It is our position, however, that in light of the absence of any legislative history expressly providing for such analysis regarding the business energy credit, and in light of the Friendship Dairies case, Congress' general favor for this type of investment does not dictate a change in the legal proposition that tax benefits do not transform unprofitable transactions into profitable ones even with alternative energy investments.

Should you have any further questions regarding this matter, please contact Jeff Rosenberg at (FTS) 566-3233.

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